COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Petition of Boston Edison Company,	)	
Cambridge Electric Light Company and	)	
Commonwealth Electric Company,	)	
d/b/a/ NSTAR Electric, for Approval of	)	DTE 05-84
Revised Tariffs M.D.T.E. Nos. 100A, 101A,	)	
200A, 201A, 300A and 301A Relating to the	)	
Terms and Conditions for Distribution	)	
Services and Competitive Suppliers.	)	

COMMENTS OF DIRECT ENERGY SERVICES LLC

INTRODUCTION

Direct Energy Services, LLC ("Direct Energy") welcomes the opportunity to comment on NSTAR Electric's proposal to restrict the right of Massachusetts electric customers to choose their electric supplier. This is an important docket, which presents the Department with an opportunity to make significant improvements in the retail market in Massachusetts while also addressing the issue raised in NSTAR's filing. Before making its substantive comments on the NSTAR proposal, Direct Energy would like to provide some general background on the Company.

Direct Energy is a leading North American retailer of energy and related services. The Company has over 5 million customer relationships in North America. Direct Energy supplies energy to consumers in Texas, Ohio, Pennsylvania, Illinois, Michigan, Maryland, New Jersey, Massachusetts, Rhode Island, and Connecticut and also in the Canadian provinces of Ontario and Alberta. In Texas and Alberta, the Company supplies energy on both a regulated and an unregulated basis. In Massachusetts, Direct Energy supplies electricity and natural gas to commercial and industrial customers, and looks to expand its offerings to residential and small commercial customers as the opportunity ripens.

Direct Energy's parent company, Centrica plc, has over 33 million customer relationships worldwide. Centrica has a market capitalization of $17.5 billion and $22 billion in annual revenues. In the United Kingdom, Centrica owns approximately 3,000 MW of generation capacity to support its retail electricity customer base. The Company is seeking to invest in excess of $1 billion in generation capacity over the next five years. In North America, the Company owns electricity generation and gas production assets in support of its retail supply business, including more than 4,000 gas wells in Western Canada and more than 1,000 MW of electric generating capacity in Texas.

In its filing, NSTAR alleges that certain retail competitive suppliers have engaged in a practice in which suppliers switch customers from competitive supply to default service at times when the default service price is low compared to the market price (presumably selling their hedged positions into the market at a profit), and then switch those customers back when the default service price is above the market price. NSTAR alleges that this practice is typically associated with large C&I customers. NSTAR claims that this practice has caused a high level of volatility in default service volumes, which has made wholesale suppliers either reluctant to bid on default service or, if they bid, to include a substantial risk premium in their bids. NSTAR's proposed solution is to administratively restrict customers who have returned to default service from returning to their previous competitive supplier for six months.

NSTAR's request should be denied, for a number of reasons. First, the filing contains scant evidence upon which the Department could make the findings necessary to order the relief requested. NSTAR presents only the testimony of James Daly in support of its request, and Mr. Daly's testimony provides little in the way of solid evidence, as discussed in more detail below. Second, the proposed change would ban a customer's exercise of his statutory right to choose his electric supplier. Third, the remedy sought by NSTAR is vastly disproportionate to the alleged problem. Taking everything NSTAR alleges as true, this is an issue with at most a handful of competitive suppliers, and the Department has means at its disposal to address this problem without encroaching on the statutory rights of all retail customers. Finally, the NSTAR filing fails to identify as the prime mover behind the alleged problem its own distorting presence as a *de facto* competitive supplier in a market segment that should have no need for the kind of "default" service NSTAR currently provides. A better solution would be to have NSTAR modify its commodity function activities for the large C&I sector.

ARGUMENT

1. The Filing Does Not Present Evidence Sufficient to Warrant Department Action.

Mr. Daly's testimony in support of the NSTAR filing presents only conclusory evidence regarding the alleged "gaming" problem. Mr. Daly alleges that there has been greater volatility in the level of default service load than the company otherwise would have predicted, and that this volatility is attributable to frequent switching between default service and competitive supply by large C&I customers, especially the customers of three competitive suppliers in particular, with one of those suppliers accounting for the majority of the switching. However, Mr. Daly provides none of the data or analysis upon which his argument is based. Neither the Department nor other market participants can examine this underlying evidence to test Mr. Daly's hypothesis. Perhaps NSTAR's analysis of expected volatility is off the mark. Perhaps other factors in the wholesale market are driving changes in bidding behavior. Perhaps there are other explanations for the switching activity noted by Mr. Daly. There is no way to answer these questions using only the information provided in Mr. Daly's testimony.

Most tellingly, there is no expert testimony regarding the specific market conditions in any three-month period during which this practice has supposedly taken place. If Mr. Daly's hypothesis is correct, one should be able to identify the points during a three-month default service pricing period when market conditions would have rewarded the alleged strategic behavior by suppliers and then show a correlation between those market conditions and actual spikes in supplier switching. This should have been a simple exercise considering that NSTAR is in possession of all switching data and thus should know where such spikes have occurred.

NSTAR did not provide other evidence that one would expect to be available if its underlying allegation were true. There is no testimony (even provided on a redacted, confidential basis) from wholesale suppliers confirming either the presence of the unexpected volatility discussed by Mr. Daly or the suppliers' resulting change in bidding practices. There is no testimony from C&I customers (again, even on a redacted, confidential basis) regarding the existence of this alleged practice. There is certainly no "smoking gun" testimony from a current or former employee of a competitive supplier confirming the existence of this practice or describing exactly how it is accomplished.

In fact, it is not clear how this scheme is accomplished in compliance with existing Department regulations. NSTAR describes this as a scheme carried out by competitive suppliers yet it is difficult to see how it could be done without at least the tacit cooperation of customers. Competitive suppliers may switch customers to default service using their access to the Electronic Data Interchange system, but to switch from default service back to a competitive supplier – even the supplier from which the customer most recently switched – requires customer consent. G.L. c. 164, § 1F(8); 220 CMR 11.05(4)(b). If the return to competitive service is being done without the customer's consent, then the switch violates G.L. c. 164, § 1F and the

Department's anti-slamming regulations, and the alleged problem could be solved by simple enforcement of those existing provisions of the law. If the return to competitive service is being done with the customer's consent, then two conditions must exist: (1) the competitive supplier's contractual arrangement with the customer must allow for frequent switching, and (2) the customer must see value in both the switch to and the switch from default service. NSTAR should provide additional information that would allow the Department to determine whether the purported effect identified by Mr. Daly is, in fact, strategic behavior by suppliers rather than rational participation by customers in a market in which the incumbent utility continues to offer what amounts to a competitive offering, namely a three-month hedged price.

Finally, even if competitive suppliers switch C&I load on and off default service, as NSTAR alleges, the filing makes no clear connection between the effect on volatility of C&I load and any negative effect on residential and small C&I customers. Mr. Daly makes the point that customers other than large high credit quality C&I customers do not have the same opportunity to "game" that such large C&I customers allegedly have, but he does not make a credible case for the impact that alleged gaming in the three-month large customer default service procurement has on the actual default service price for such customers. At this point, default service for medium and large C&I customers is procured on a fixed three-month contract. Default service for residential and small C&I customers is provided by procuring 50 percent of the load every six months on a twelve month contract. Mr. Daly provides no explanation for the mechanism whereby volatility in the large C&I market drives up prices for small default service customers whose price is determined through a completely separate process, although he alleges that "gaming" raises prices for all customers. Daly Testimony at 9. In fact, one might expect that the relative stability of residential and small C&I customers who, as Mr. Daly himself argues, have no opportunities for gaming and few competitive supply options, would make those procurements more attractive than the three-month medium and large C&I procurement to wholesale suppliers, perhaps creating more competition in those procurements, with a corresponding downward pressure on default service prices for small customers. This is an important point for the Department to investigate since the volatility of which NSTAR complains may be of much less concern if it is confined to a customer sector that has greater competitive options and for which, as discussed further below, there is a simple solution for any unfair strategic practices by competitive suppliers.

2. The Proposed Remedy Is Not Allowed Under the Restructuring Act.

Even if NSTAR provides stronger evidence of strategic behavior by competitive suppliers, the remedy sought – a restriction on the right of customers to take electric service from the supplier of their choice – is not allowed under the Restructuring Act.

As a threshold matter, the Department should find – and NSTAR cannot deny – that the alleged practice of which they complain is not unlawful. In its filing, NSTAR did not allege that competitive suppliers were switching customers without their consent, which would be a violation of both the Restructuring Act and Department regulations. NSTAR did not allege that any customer who might be participating in such a scheme somehow avoids paying the true cost of default service. This is not a situation in which a customer "games" a fixed price default service offering by taking default service during high-cost months, when the fixed price will tend to be lower than the market, and returns to competitive supply during low-cost months, when the fixed price will tend to be higher than the market. The Department's fixed-price to monthly-price true-up mechanism removes any incentive for a customer to switch in that manner.

What NSTAR describes appears to be no more than large C&I customers making what they believe to be rational business decisions in the context of the default service system as created by the Restructuring Act and implemented by the Department. The Department has no authority to outlaw that behavior, as suggested by NSTAR. The Restructuring Act's governing dynamic is customer choice and the right to choose is set forth explicitly in the Act:

> The department is hereby authorized and directed to require electric companies organized pursuant to the provisions of this chapter to accommodate retail access to generation services and choice of suppliers by retail customers, unless otherwise provided by this chapter.

G.L. c. 164, § 1A(a). This is the very first sentence of the substantive revisions to G.L. c. 164 made by the Restructuring Act, and it could not be clearer. The Department is directed to require electric companies to accommodate retail access to generation services and choice of suppliers by retail customers, unless otherwise provided by this chapter. There is no other provision of "this chapter" that gives the Department the authority to restrict any customer's right of choice of a retail supplier, much less every customer's right to do so.[1]

The Restructuring Act did authorize the Department to promulgate rules and regulations for the creation and administration of standard offer service and default service, "including the procedure for default service procurement and governing a customer's ability to return to the standard service after choosing retail access from a non-utility affiliated generation company." G.L. c. 164, § 1A(f) (emphasis added). However, the remedy sought by NSTAR has nothing to do with the default service procurement. It is a blatant restriction on the right of retail customers to choose their electric suppliers and such a restriction is not allowed by any provision of the Restructuring Act.

[1] Although Mr. Daly's testimony alleges only "gaming" with respect to large C&I customers, the proposed tariff revisions would apply to all customers.

Moreover, even taking NSTAR's allegations as true, it is clear that there are circumstances in which a large C&I customer might wish to return to its previous competitive supplier after a stay of less than six months on default service that do not involve "gaming." A customer could decline to renew a contract with a competitive supplier because they find the next three month default service price to be attractive, and then be won back by the same competitive supplier when the next three month default service price was announced. This would not be "gaming," as the supplier would not have moved the customer to default service in order to sell its hedge into the market at a profit. It would simply be a supplier losing and then winning back a customer.

Mr. Daly acknowledges that this type of migration is inherent in the system and that NSTAR does not view it as gaming:

> Presently, wholesale suppliers have difficulty estimating the level of load that will be served because load is free to leave Default Service and choose a competitive supplier. Load tends to migrate off Default Service when prices in the wholesale market decrease as competitive suppliers have more opportunity to beat the Default Service price and attract customers from Default Service. In these circumstances, the wholesale supplier will be left with higher priced power that they will likely sell at a loss in a lower priced market. Wholesale suppliers must build in a margin to cover such losses, which results in higher prices for Default Service.
>
> In addition, wholesale suppliers that are serving Default Service customers can realize losses when prices rise after the beginning of the Default Service contract term if load migrates back to Default Service from retail competitive suppliers that may not be willing to serve customers at prices below the Default Service price. Wholesale suppliers must build in a margin to cover such possible losses and, therefore, these additional margins result in higher prices for Default Service than would otherwise be offered if volatility were not a factor in bidding on Default Service load. **However, this normal level of volatility is a basic design feature of Default Service that is priced into the service and borne by all Default Service customers**.

Daly testimony at 5-6 (emphasis added).

NSTAR's proposed remedy, however, would restrict even customers who are engaging in the type of switching identified by Mr. Daly as a "basic design feature of Default Service." So long as the Department requires utilities to provide C&I customers with default service in the form of a fully-hedged three-month offering, there will be customers who will find this attractive versus the other competitive offerings available at the time. Customers have the right to make that choice without being penalized with a restriction on their right to return to competitive supplier service.

3. Even If the Problem Exists, Other Remedies Would Be Far Superior.

While the NSTAR filing does not provide a sufficient basis for the Department taking any action that would restrict a customer's right to choose his electric supplier, it is possible that a handful of competitive suppliers may be engaging in strategic behavior that has a negative impact on default service procurement and pricing.

a. <u>Since, according to NSTAR, three suppliers account for the overwhelming majority of the problem, the Department should start with a confidential investigation of those suppliers.</u>

According to Mr. Daly's testimony, only a few competitive suppliers engage in the alleged practice to any appreciable extent:

> For the two years studied, approximately 36 percent of the large C&I customer accounts that switch from competitive supply to Default Service switched back to competitive supply during the year. Of those accounts, 82 percent return to the same competitive supplier. Almost the entirety of multiple switches is attributable to three retail competitive suppliers in 2004 and 2005, with one of these suppliers accounting for approximately 72 percent of the multiple switches.

Daly testimony at 7.

Rather than imposing what would be overly broad and restrictive remedy on all C&I customers, Direct Energy encourages the Department to engage in direct discussions with the three suppliers identified by NSTAR in an attempt to resolve the matter amicably or to fashion a more targeted remedy based on the Department's broad authority over competitive suppliers. If the Department does not have the authority to directly remedy the behavior of the suppliers who actually engage in the practice, it does not have authority to impose a broader remedy on all suppliers and all customers.

b. A far more effective remedy would be hourly pricing for large C&I customers.

Rather than imposing restrictions on a customer's right to choose electric suppliers, Direct Energy encourages the Department to adopt a measure that would make the alleged "gaming" uneconomic while also accomplishing a number of other important policy goals for the competitive market: hourly default pricing for large C&I customers. The Department considered hourly pricing in Default Service, DTE 02-40-C (September 11, 2003), noting that while it might be "the most direct way to resolve the price certainty and price efficiency issues" considered in that proceeding, it was not an appropriate measure at the time because of concerns that it would "expose customers to significant risk that spot market prices could skyrocket during certain hours, causing substantial financial harm to customers," thus posing "an unacceptable risk for customers that may appropriately be using default service as a short-term, last resort service." DTE 04-40-C, at 21, citing DTE 02-40-B, at 37-39.

Direct Energy respectfully submits that the experiences of the past two years have shown that hourly pricing for large C&I customers is an idea whose time has come. Other states, notably New Jersey, have adopted this pricing mechanism for large C&I customers (all customers over 1,250 kW) and have not seen any of the potential financial harm to customers that caused the Department legitimate concern in 2003. In fact, the New Jersey Board of Public Utilities has been sufficiently pleased with the results of this program (64 percent of large customers, representing more than 84 percent of load, have switched to competitive supply) that the Board is "cautiously aggressive" in its intention to expand "the spectrum of hourly-priced customers." *Public Utilities Fortnightly*, September 2005, at 16. Moreover, in Texas, customers greater than 1,000 kW do not receive any default service. Again, there have been no negative outcomes from this model.

Hourly pricing for this customer sector would eliminate completely “gaming” attempts by large customers or suppliers serving them. It would also eliminate the volatility premium identified by Mr. Daly by eliminating the procurement process in which wholesale suppliers take on migration risk.

Hourly pricing would also accomplish other important policy goals. It would send a strong signal that utilities will no longer be in the business of managing supply for large customers. This problem is one that underlies the gaming problem that is the subject of NSTAR’s filing. So long as utilities procure supply for large customers in any manner other than through pass-through hourly pricing, customers and suppliers will come to rely on default service for strategic and tactical purposes. Even the “normal” volatility identified by Mr. Daly is not the sign of a healthy competitive retail market because the utility three-month price distorts what would otherwise be an efficient range of choices provided by competitive suppliers.

The same would be true of any other commodities market in which buyers have the choice of entering into bilateral agreements with sellers or relying on a highly volatile short-term spot market. No one would suggest that the government order a public utility-type entity to procure coal or oil or pork bellies on a series of three-month fixed price contracts to serve those buyers that did not want to make a choice between a bilateral contract with a private seller and buying on the spot market. The past several years have shown that large C&I electric customers should be treated no differently from large consumers of other commodities who have a robust range of competitive options. They need to choose among those options, including the option of hourly pricing (which some large customers might, in fact, prefer) rather than relying on a utility-provided hedged-offering as a safety valve. Hedging and other competitive services should be provided by marketers, not utilities.

Moreover, by sending very accurate price signals to large C&I customers who chose to stay on default service, hourly pricing would facilitate the demand response that is increasingly critical to the health of the New England grid. While the Department had legitimate concerns in 2003 that hourly pricing might expose some customers to very high spot market prices in hours of peak system demand, it is now clear that large customers often have the ability to respond to such price signals by reducing their demand, saving money and easing the burden on the overall system in the process.[2] Large customers who are able to shed load in that manner are likely to find hourly pricing in conjunction with a demand response program to be quite advantageous versus the current three-month default service price or even competitive offerings. Large customers who do not have such flexibility need a hedged product, which they should be required to buy from the competitive market rather than the distribution company.

4. The Real Problem Is Not Supplier or Customer Behavior But Basic Market Design.

The behavior described in the NSTAR proposal is a direct result of the continued presence of utility generation service as a "competitive" offering. As discussed above, default service is no longer serving the purpose for which it was originally intended, that is, to be a true "POLR" service, available when customers lost their competitive supplier for reasons beyond their control, such as supplier bankruptcy or exit from the market. For smaller customers, it is

[2] Recently, ISO-NE President and CEO Gordon van Welie highlighted this critical interrelationship between the wholesale and retail markets: "[W]e need well-functioning wholesale and retail markets to fulfill the promise of restructuring. But the two cannot exist in parallel universes. Each needs to be linked to the other to work properly. By creating strong links between the two, both can be strengthened, enabling the markets to deliver benefits to all consumers." He went on to say "[W]e need more direct participation of consumers in the markets. In order to achieve this outcome, consumers need to see and pay the price for their consumption decisions. If customers pay the same retail electricity price hour-to-hour, day-to-day, and month-to-month, they have no incentive to change how they use electricity." ISO-NE Regional Energy Forum, "Connecting Wholesale and Retail Electricity Markets," October 17, 2005.

the service of <u>first</u> rather than last resort. For large customers, who clearly have plenty of options in the competitive market, default service simply acts as another competitive offering, specifically a fully-hedged three-month fixed price. It is no wonder that NSTAR has observed the behavior described in Mr. Daly's testimony. Customers (and suppliers, to the extent they in fact engage in "gaming") are acting in a rational manner by making use of the options presented in the marketplace.

The only permanent solution to the situation identified in the NSTAR filing is to get the utility out of the commodity business. So long as distribution utilities such as NSTAR offer pass-through wholesale commodity service, that service will be treated by customers and suppliers as a competitive option, altering the behavior of both groups and thus distorting the market. NSTAR is particularly aggressive in its apparent desire to continue in this role. In just the past several weeks, it has filed two proposals that would, if approved by the Department, make it both more difficult for large customers to leave default service (the filing at issue in this case) and more attractive for small customers to remain on default service (the proposed rate settlement that would include laddering of procurement contracts of up to three years in length for residential customers).

These filings are only the latest in a series of attempts by NSTAR to find a scapegoat for problems in the retail markets that are caused to a great extent by its own continued direct participation in those markets. Such arguments, (which have pointed the finger variously at wholesale suppliers, LICAP, retail suppliers, and now customers themselves), attempt to create the illusion that NSTAR has the capacity to manage supply for a large group of retail customers on a permanent or near-permanent basis. This is simply not the case, and market rules such as the one NSTAR suggests in this proceeding, that further this illusion only retard the development of a robust retail market that would obviate the need for any role for the utility in wholesale procurement, other than perhaps as a true provider of last resort.

CONCLUSION

For the reasons discussed above, Direct Energy respectfully requests that the Department deny NSTAR Electric's request to restrict customers' rights to switch from default service to the competitive supplier of their choice at any time. The NSTAR proposal ignores obvious and effective measures – including hourly pricing – in favor of restrictions on a customer's fundamental right to choose suppliers. NSTAR's suggested cure is far worse than the disease and it should be rejected in favor of either no action or the adoption of hourly pricing for large C&I customers who choose to remain on default service.

Respectfully submitted,

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Christopher H. Kallaher
Robinson & Cole LLP
One Boston Place
Boston, MA 02108
(617) 557-5900

Patrick G. Jeffery
Vice President, Government Affairs
Direct Energy Services, LLC
263 Tresser Boulevard
One Stamford Plaza, 8th Floor
Stamford, CT 06901
(207) 604-0364

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